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UNCLAS SECTION 01 OF 02 YEREVAN 001662

SIPDIS

SENSITIVE

STATE FOR EUR/CACEN FOR SIDEREAS, EUR/ACE FOR LONGI

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TAGS: [ECON](#) [ETRD](#) [EINV](#) [EIND](#) [AM](#) [RU](#)

SUBJECT: ARMENIA TRIES TO SQUEEZE VALUE FROM DIAMONDS

[1](#)1. (U) Sensitive but unclassified. Please protect accordingly.

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SUMMARY  
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[1](#)2. (U) While constituting only 5 percent of GDP, Armenia's rapidly expanding diamond cutting industry attracts both strong domestic attention and significant foreign investment. Precious and simple to transport, diamonds overcome Armenia's closed borders and high transport costs. A history of diamond cutting, low wages, and a preferential quota arrangement with Russia fueled early growth in the diamond sector. Increases in diamond production have caused a sharp, albeit specious, increase in Armenia's trade numbers, and have proved a handy source of foreign currency. On the other hand, the industry brings almost no tax revenue to government coffers. The government is looking to a new strategy to encourage diamond polishers to sell their diamonds and thus take their profits in Armenia. Investment by the diamond industry's heavy hitters suggests that wholesale diamond sales could have a future in Armenia, which would transform the industry from an expanding source of jobs to a strong growth sector. End Summary.

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DIAMOND CUTTING HERALDS GROWTH IN EXPORTS...  
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[1](#)3. (U) Strong growth in the diamond cutting industry has greatly expanded Armenia's external economy, despite having little effect on its domestic books. Since 1998 exports of diamonds have increased seven fold to nearly USD 378 million in 2003 (imports of raw diamonds expanded from USD 45 million to USD 343 million over the same period). Exports of diamonds accounted for 53.5 percent of all exports and the continuing expansion of the inward processing diamond industry pushed up overall exports and imports markedly, causing trade to increase by 35 percent in dollar terms in [1](#)2003.

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...BUT NOT GDP  
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[1](#)4. (U) Despite large effects on Armenia's trade statistics, diamond processing barely leaves a mark on Armenia's GDP, or for that matter, tax revenues. The value added in diamond polishing is low, from 5 to 10 percent, and most diamonds are processed in Armenia and sold on low, cost-plus terms to parent companies abroad. The diamond industry brings only a couple million dollars per year in profit tax revenue, and no VAT revenue as diamonds are exempted as an export industry. Because Armenia captures so little of a diamond's value added in Armenia, the sector's value to the Armenian economy is in effect limited to the 5,500 jobs it provides, with average monthly wages of USD 300.

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SQUEEZING VALUE FROM A DIAMOND  
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[1](#)5. (SBU) According to Gagik Mkrtchian, Head of the Department of Gems and Jewelry at the Ministry of Trade and Economic Development, the government is seeking to capture more of the industry's value-added by encouraging wholesale sales of loose diamonds in country. According to Mkrtchian, his office has submitted a plan to create a diamond sales center in Armenia that could be one-stop-shop for wholesale buyers, providing a forum for the diamond factories to exhibit diamonds and for buyers to secure necessary export and Kimberley process documentation. While Mkrtchian's plans are still abstract, Armenia's largest diamond factory has put the same idea into bricks and mortar. On a recent visit to the Shoghakn factory, owned by the world's largest private diamond manufacturer, Lev Leviyev, the factory manager showed the Ambassador a new building that has been finished as a showroom for wholesale buyers. The manager said they intend to bring sales of wholesale diamonds to Armenia, operating from the factory showroom. According to Mkrtchian, sales of finished loose diamonds could capture up

to 30 percent of the diamond's value added in Armenia. While having little effect on the company's balance sheets, moving sales to Armenia could have a great effect on Armenia's books. While sales would be exempt for VAT tax (diamonds are exempt until set into jewelry) any sales here would be revenues recorded in Armenia on which the Armenian incorporated subsidiary would have to pay profit tax.

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BIG PRODUCERS LOOK BEYOND RUSSIAN SUPPLIES  
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16. (SBU) As the diamond sector expands in Armenia and the industry's largest players expand their operations here, the case for bringing sales here grows stronger. The ultimate sustainability of Armenia's diamond sector depends on its diamond firms becoming global players and less dependant on waning Russian supply. No factor is more important to the success of a diamond factory than ensuring a consistent supply of raw diamonds. Of Armenia's 50 diamond-polishing factories, few are large players who can secure supply lines worldwide. The Aslanian family, partnered with the prestigious diamond firm Rosy Blue, operates a diamond factory in Lori province supplied from Belgium with high quality diamonds from around the world. Lev Leviyev, an Israeli (also a Russian citizen) billionaire from Uzbekistan, procures diamonds for his Shoghakn plant from various mines in Africa. The Diamond Company of Armenia, owned by the British Ferfano Company, sources its production of 8,000 carats per month from De Beers.

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SMALL PRODUCERS LOOK THREATENED  
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17. (SBU) Armenia's smaller producers depend on a preferential quota agreement with Alrosa, the Russian diamond supplier. Each year the Russian government permits export of up to 400,000 carats of rough diamonds to Armenia, which are distributed among Armenia's operating diamond factories. The actual number of diamonds received from Russia is much smaller. In 2003 Armenian factories received only 130,000 carats of raw diamonds from Russia, and they have received 100,000 carats in the first six months of 2004. Shoghakn's general manager insists that Russian supply is increasingly less important as prices are rising and the quotas are unfulfilled. Mkrtchian added that many of the smaller factories are now idle, and prospects for the future of Russian supply are not good. As Russia moves to accede to the WTO, Mkrtchian reminded us, it must end preferential supply arrangements and Alrosa's quota system. Mkrtchian concluded that the future of Armenia's diamond industry depends on the leadership of the large diamond producers.

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COMMENT  
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18. (SBU) As the preferential supply of Russian diamonds wanes, the future of Armenia's diamond sector depends on the ability of the GOAM to encourage the big producers to expand their Armenian operations and to consolidate efforts to bring buyers to Armenia. The prospect of onward sales present tempting rewards for tax revenue, and Armenia has (rightly) chosen to tread lightly on the industry, exempting diamond producers from the VAT hassles that burden other exporters. Diamond companies can easily shift production among their factories, and continued diamond-friendly tax policy will encourage the big producers to expand and open wholesale operations in Armenia.

ORDWAY